(3) *Adjustments by the Internal Revenue Service.* In connection with the examination of a return, the District Director may increase (or decrease) AGUB for items other than those described in paragraphs (g)(1) and (2) of this section under the authority of section 338(b)(2) and allocate such amounts to target's assets under the authority of section 338(b)(5) so that AGUB and the basis of target's assets properly reflect the cost to the purchasing corporation of its interest in target's assets. Such items may include distributions from target to the purchasing corporation, capital contributions from the purchasing corporation to target during the 12-month acquisition period, or acquisitions of target stock by purchasing corporation after the acquisition date from minority shareholders.

(h) *Examples.* (1) For purposes of the examples in this paragraph (h), T has no liabilities other than a tax liability resulting from the deemed sale of assets.

(2) This section may be illustrated by the following examples:

Example 1. (a) Before July 1 of Year 1, P purchases 10 of the 100 shares of T stock for $5,000. On July 1 of Year 2, P purchases 80 shares of T stock for $60,000 and makes a section 338 election for T. As of July 1 of Year 2, T's only asset is raw land with an adjusted basis to T of $50,400 and a fair market value of $100,000. T has no loss or tax credit carryovers to Year 2. T's marginal tax rate for any ordinary income or net capital gain resulting from the deemed sale of assets is 34%. The 10 shares purchased before July 1 of Year 1 constitute nonrecently purchased T stock with respect to P's qualified stock purchase of T stock on July 1 of Year 2.

(b) The ADSP formula as applied to these facts is the same as in *Example 2* of §1.338–3(d)(9). Accordingly, the ADSP of T is $87,672.72. The existence of nonrecently purchased T stock is irrelevant for purposes of the ADSP formula, because that formula treats P's nonrecently purchased T stock in the same manner as T stock not held by P.

(c) The total tax liability resulting from T's deemed sale of assets, as calculated under the ADSP formula, is $12,672.72.

(d) If P does not make a gain recognition election, the AGUB of new T's assets is $85,172.72, determined as follows. (In the formula below, GRP is the grossed-up basis in P's recently purchased T stock, BNP is P's basis in nonrecently purchased T stock, L is T's liabilities, and X is other relevant items.)

$$AGUB=GRP+BNP+L+X$$
$$AGUB=\$60{,}000\times[(1-.1)/.8]+\$5{,}000+\$12{,}672.72+0$$
$$AGUB=\$85{,}172.72$$

(e) If P makes a gain recognition election, the AGUB of new T's assets is $87,672.72, determined as follows:

$$AGUB=\$60{,}000\times[(1-.1)/.8]+\$60{,}000\times[(1-.1)/.8]\times[.1/(1-.1)]+\$12{,}672.72$$
$$AGUB=\$87{,}672.72$$

(f) The calculation of AGUB if P makes a gain recognition election may be simplified as follows:

$$AGUB=\$60{,}000/.8+\$12{,}672.72$$
$$AGUB=\$87{,}672.72$$

(g) As a result of the gain recognition election, P's basis in its nonrecently purchased T stock is increased from $5,000 to $7,500 (i.e., $\$60{,}000\times[(1-.1)/.8]\times[.1/(1-.1)]$). Thus, P recognizes a gain in Year 2 with respect to its nonrecently purchased T stock of $2,500 (*i.e.*, $\$7{,}500-\$5{,}000$).

Example 2. On January 1 of Year 1, P purchases one-third of the T stock. On March 1 of Year 1, T distributes a dividend to all of its shareholders. On April 15 of Year 1, P purchases the remaining T stock and makes a section 338 election for T. In appropriate circumstances, the District Director may decrease the AGUB of T to take into account the payment of the dividend and properly reflect the fair market value of T's assets deemed purchased.

Example 3. (a) T's sole asset is a building worth $100,000. On August 1 of Year 1, P purchases 10 of the 100 shares of T stock for $8,000. On June 1 of Year 2, P purchases 50 shares of T stock for $50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are $10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for $40,000 and makes a section 338 election for T. The AGUB of T is $108,800.

(b) To prevent the shifting of basis from the contributed property to other assets of T, the District Director may allocate $10,800 of the AGUB to the land, leaving $98,000 to be allocated to the building.

[T.D. 8515, 59 FR 2979, Jan. 20, 1994]

§1.338(b)–2T Allocation of adjusted grossed-up basis among target assets (temporary).

(a) *Introduction*—(1) *In general.* This section prescribes rules under section 338(b)(5) for allocating adjusted grossed-up basis among the assets of a target for which a section 338 election is made.

(2) *Fair market value.* The *fair market value* of an asset is the gross fair market value of that asset (*i.e.*, fair market value determined without regard to mortgages, liens, pledges, or other liabilities).

(b) *General rule for allocating adjusted grossed-up basis*—(1) *Cash and other items designated by the Internal Revenue Service.* Adjusted grossed-up basis is first reduced by the amount of Class I assets. Class I assets are cash, demand deposits and similar accounts in banks, savings and loan associations (and other similar depository institutions), and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service.

(2) *Other assets*—(i) *In general.* Subject to the limitations and other special rules of paragraph (c) of this section, adjusted grossed-up basis (as reduced by Class I assets) is allocated among Class II assets of target held at the beginning of the day after the acquisition date in proportion to their fair market values at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, and finally to Class V assets.

(ii) *Class II assets.* Class II assets are certificates of deposit, U.S. Government securities, readily marketable stock or securities (within the meaning of §1.351–1(c)(3)), foreign currency, and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service.

(iii) *Class III assets.* Class III assets are all assets of target other than Class I, II, IV, and V assets.

(iv) *Class IV assets.* Class IV assets are all section 197 intangibles, as defined in section 197, except those in the nature of goodwill and going concern value.

(v) *Class V assets.* Class V assets are section 197 intangibles in the nature of goodwill and going concern value.

(c) *Certain limitations and special rules for basis allocable to an asset*—(1) *Basis not to exceed fair market value.* The amount of adjusted grossed-up basis allocated to an asset (other than Class V assets) shall not exceed the fair market value of that asset at the beginning of the day after the acquisition date. For modification of this fair market value limitation with respect to certain contingent income assets, see § 1.338(b)–3T(g).

(2) *Assets subject to other limitations.* The amount of adjusted grossed-up basis allocated to an asset shall be subject to the limitations under the provisions of the Internal Revenue Code or principles of tax law in the same manner as if such asset were acquired from an unrelated person in a sale or exchange. For example, if the deemed sale (and purchase) of assets is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of adjusted grossed-up basis allocated to a contract for the services of an athlete shall not exceed the limitation imposed by that section. For another example, see § 1.338(b)–1(f)(2), relating to excluded obligations.

(3) *Special rule for allocating adjusted grossed-up basis when purchasing corporation has nonrecently purchased stock*—(i) *Scope.* This paragraph (c)(3) applies if at the beginning of the day after the acquisition date (A) the purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and § 1.338(b)–1(e)(2) is not made and (B) the hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the adjusted grossed-up basis determined under § 1.338(b)–1(c)(1). The determinations required under the preceding sentence shall be made without regard to adjustment events occurring after the close of new target's first taxable year.

(ii) *Determination of hypothetical purchase price.* Hypothetical purchase price is the sum of the grossed-up basis of recently purchased stock as determined under § 1.338–3(d)(2) and liabilities of target.

(iii) *Allocation of adjusted grossed-up basis.* Subject to the limitations in paragraphs (c)(1) and (2) of this section, adjusted grossed-up basis (after reduction by the amount of Class I assets) is allocated among Class II, III, IV, and V assets of target held at the beginning of the day after the acquisition date in proportion to their fair market values at such time. For this purpose, the fair market value of Class V assets is deemed to be the excess, if any, of the hypothetical purchase price over the sum of the amount of the Class I assets and the fair market values of the Class II, III, and IV assets.

(4) *Effective dates.* This section applies for acquisition dates on or after February 14, 1997. For acquisition dates before February 14, 1997, if section 197 does not apply to any asset deemed acquired, the provisions of the regulations in effect before February 14, 1997, apply (see § 1.338(b)–2T as contained in 26 CFR part 1 revised April 1, 1996). For acquisition dates before February 14, 1997, if section 197 applies to any asset deemed acquired, the taxpayer (and all related parties) may consistently (in all transactions in which AGUB, ADSP, MADSP, or consideration must be allocated under section 338 or 1060)—

(i) Apply the provisions of this section;

(ii) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.338(b)–2T as contained in 26 CFR part 1 revised April 1, 1996); or

(iii) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.338(b)–2T as contained in 26 CFR part 1 revised April 1, 1996), but treat all amortizable section 197 intangibles as Class IV assets.

(d) *Examples.* The provisions of this section and § 1.338(b)–1 may be illustrated by the following examples:

Example (1). (i) T owns 90% of the outstanding T1 stock. P purchases 100% of the outstanding T stock for $2,000. A section 338 election is made for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is $2,000 (i.e., $2,000 × 1/1).

(ii) Assume that the liabilities of T as of the beginning of the day after the acquisition date (including income tax liabilities arising on the deemed sale of its assets) are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities)	$700
Taxes payable	300
Total	1,000

(iii) The adjusted grossed-up basis (''AGUB'') of T is determined as follows:

Grossed-up basis	$2,000
Total liabilities	1,000
AGUB	3,000

(iv) Assume that, at the beginning of the day after the acquisition date, T's cash and the fair market values of T's Class II and III assets are as follows:

Asset class	Asset	Fair market value
I	Cash	*$200
II	Portfolio of marketable securities	300
III	Inventory	300
III	Accounts receivable	600
III	Building	800
III	Land	200
III	Investment in TI	450
	Total	2,850

*Amount.

(v) Under paragraph (b)(2) of this section the amount of AGUB allocable to T's Class II and III assets is reduced by the amount of cash to $2,800, *i.e.,* $3,000 − $200. $300 of AGUB is then allocated to marketable securities. Since the remaining amount of AGUB is $2,500 (*i.e.,* $3,000 − ($200 + $300)), an amount which exceeds the sum of the fair market values of T's Class III assets, the amount allocated to each Class III asset is its fair market value:

Inventory	$300
Accounts receivable	600
Building	800
Land	200
Investment in T1	450
Total	2,350

(vi) T has no Class IV assets. The amount allocated to T's Class V assets (assets in the nature of goodwill and going concern value) is $150, i.e., $2,500–$2,350.

(vii) The grossed-up basis of the T1 stock is $500, *i.e.,* $450×1/.9.

(viii) Assume that the liabilities of T1 as of the beginning of the day after the acquisition date (including income tax liabilities arising on the deemed sale of its assets) are as follows:

General liabilities	$100
Taxes payable	20
Total	120

(ix) The AGUB of T1 is determined as follows:

Grossed-up basis of T1 stock	$500
Liabilities	120
AGUB	620

(x) Assume that at the beginning of the day after the acquisition date, T1's cash and the fair market values of its Class III and IV assets are as follows:

Asset class	Asset	Fair market value
I	Cash	$50*
III	Equipment	200
IV	Patent	350
	Total	$600

*Amount

(xi) The amount of AGUB allocable to T1's Class III and IV assets is first reduced by the $50 of cash.

(xii) Since the remaining amount of AGUB ($570) is an amount which exceeds the fair market value of T1's only Class III asset, the equipment, the amount allocated to the equipment is its fair market value ($200). After that, the remaining amount of AGUB ($370) exceeds the fair market value of T1's only Class IV asset, the patent. Thus, the amount allocated to the patent is its fair market value ($350).

(xiii) The amount allocated to T1's Class V assets (assets in the nature of goodwill and going concern value) is $20, i.e., $570 − $550.

Example (2). (i) Assume that the facts are the same as in *Example (1)* except that P has, for five years, owned 20% of T's stock, which has a basis in P's hands at the beginning of the day after the acquisition date of $100, and P purchases the remaining 80% of T's stock for $1,600. P does not make a gain recognition election under section 338(b)(3).

(ii) Under § 1.338(b)-1(d), the grossed-up basis of recently purchased T stock is $1,600, *i.e.*, $1,600×(1 − .2)/.8.

(iii) The AGUB of T is determined as follows:

Grossed-up basis of recently purchased stock	$1,600
Basis of nonrecently purchased stock	100
Liabilities	1,000
AGUB	2,700

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

Grossed-up basis of recently purchased stock as determined under § 1.338–3(d)(2) ($1,600/.8)	$2,000
Liabilities	1,000
Total	3,000

(v) Since the hypothetical purchase price ($3,000) exceeds the AGUB (and no gain recognition election is made under section 338(b)(3)), AGUB is allocated under paragraph (c)(3) of this section.

(vi) The amount of AGUB ($2,700) available to allocate to T's assets is reduced by the amount of cash to $2,500, i.e., $2,700 − $200. This $2,500 balance is then allocated among the Class II, III, IV, and V assets in proportion to, and not in excess of, their fair market values (as determined under § 1.338(b)–2T(c)(3)(iii)).

(vii) Under paragraph (c)(3) of this section, the fair market value of the Class V assets is deemed to be $150, i.e., the $3,000 hypothetical purchase price minus $2,850 (the sum of T's cash, $200, and the fair market value of its Class II, III, and IV assets, $2,650). The allocation is as follows:

Portfolio of marketable securities	*$268
Inventory	268
Accounts receivable	536
Building	714
Land	178
Investment in T1	402
Goodwill and going concern value	134
Total	$2,500

*All numbers rounded for convenience.

(viii) If the AGUB of T is increased (or decreased) as a result of a subsequent adjustment, the hypothetical purchase price and the deemed fair market value of the Class V assets shall be redetermined and the increase (or decrease) in AGUB shall be allocated among T's acquisition date assets pursuant to § 1.338(b)–3T(f). The increase (or decrease) in AGUB is allocated pursuant to § 1.338(b)–3T(f) even if the hypothetical purchase price, as redetermined, no longer exceeds AGUB, as redetermined.

[T.D. 8072, 51 FR 10624, Mar. 28, 1986 as amended by T.D. 8092, 51 FR 23742, July 1, 1986; 51 FR 33033, Sept. 18, 1986; T.D. 8515, 59 FR 2960, Jan. 20, 1994; T.D. 8515, 59 FR 2981, Jan. 20, 1994; T.D. 8515, 59 FR 2984, Jan. 20, 1994; T.D. 8711, 62 FR 2269, Jan. 16, 1997]

§ 1.338(b)–3T Subsequent adjustments to adjusted grossed-up basis (temporary).

(a) *Scope*—(1) *In general.* This section provides rules for redetermining adjusted grossed-up basis to account for adjustment events that occur after the close of new target's first taxable year. These adjustments must be made upon the payment of contingent amounts for recently or nonrecently purchased stock, the change in a contingent liability of old target to one which is fixed and determinable, reductions in the amounts paid for recently or nonrecently purchased stock, and reductions in liabilities of target (and the liabilities to which its assets are subject) that were taken into account in determining adjusted grossed-up basis. Adjusted grossed-up basis is redetermined under this section only if such